BELVÉDÈRE
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CHINA, YOUR FRIEND AND FOE

MARKET INSIGHTS

CHINA, YOUR FRIEND AND FOE

Until recently, things were clear(ish) – China is huge, has opened up and is growing at an extraordinary pace. True, control is heavily centralised and the state-imposed economic drive and transformation also breeds imbalances and risks. But there was little doubt that the country would keep gaining economic and political clout. China became friends with Western companies. This was mostly owed to the massive distribution opportunities the world's most populous and investment-prone country had to offer. However, as the "workbench of the world", China also became an essential supplier to the global value chains. The low-cost products also kept inflation in check.

Now, some cracks have opened up in these presumed certainties – for instance in growth. Not only is China currently undergoing a slowdown phase (partly self-inflicted, due to the restrictive zero-covid policy). The longer-term growth story has also been dealt a blow. The usual pattern of boosting lending is running out of steam. This is basically to be welcomed, as many of the investments induced that way are unproductive and merely create overcapacity in manufacturing, infrastructure and the real estate sector. But it also puts pressure on growth, as does the fact that, according to UN estimates, the working-age population is about to decrease significantly over the next 25-30 years.

The international community's attitude towards China has cooled off significantly in the recent past. The reasons for this include China's unequable trade practices, human rights violations, an increasingly totalitarian surveillance state under Xi Jinping, and the pursuit of a geopolitical agenda through investments in foreign companies and infrastructure. Much of this comes as no surprise, but has often been blocked out for the sake of business opportunities. Specifically, China's trade practices were drawn to the broader public's attention when Donald Trump started to criticise them vociferously. What is new is that companies are now turning away from China also for business reasons. In the wake of the corona crisis, many companies have started questioning their cooperation focus and supply dependencies on one single country and are increasingly considering other production locations for the purpose of diversification and out of security considerations.

Pragmatism or ethics? Friend or foe? When it comes to dealing with China, the pendulum seems to be currently swinging towards foe and ethics. For strategic and geopolitical reasons, governments are taking more censorious action than the business community, which still sees China as a huge market with a lot of potential. "Change through trade" used to stand for the hope of reconciling both. So far, this has not panned out, though. And what about the future? After all, China's leadership has enshrined as its main goal in the statutes of the Party Congress of 2017 to offer its population a better life by 2049 (the centennial anniversary of the People's Republic of China). If it is serious, it will need to stop standing against the rest of the world in the long run to make this work.

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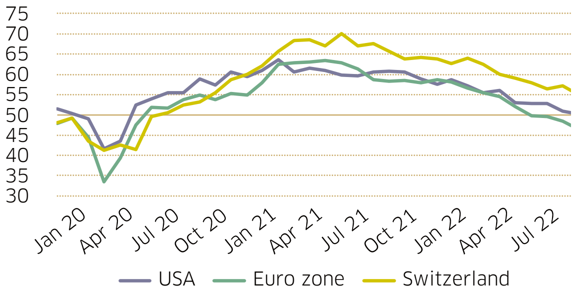
ECONOMY

At first glance, economic growth in the US was robust at 2.6% in the third quarter (compared to the prior quarter, annualised). However, on closer inspection this figure turns out to be mainly due to foreign trade and a surge in energy exports. The crucial private consumption has weakened and high interest rates have lead to a slump in the construction sector. We reckon with a slowdown in growth, but not quite a recession. The labour market is too strong for that, with more than 10 million jobs on offer, and savings from the covid era are still astonishingly high at around USD 1,700 billion.

In the euro zone, growth has already slowed down significantly in the third quarter. Simultaneously, price increases accelerated from 10% in September to 10.7% in October, which will put a strain on consumption. Both the Purchasing Managers' Indices (PMI) for manufacturing and for the services sector continue to decline and are below the growth threshold of 50 points (see chart). The euro zone is thus heading for a recession. However, the 66% drop in gas prices since the peak and the full gas storage facilities could prevent an overly severe recession. The Swiss economy can dodge the negative trends in the euro zone at least to some extent, with a manufacturing PMI still above 50 points and a comparatively moderate inflation of just above 3%.

Comparison of Purchasing Managers' Indices (growth threshold = 50)



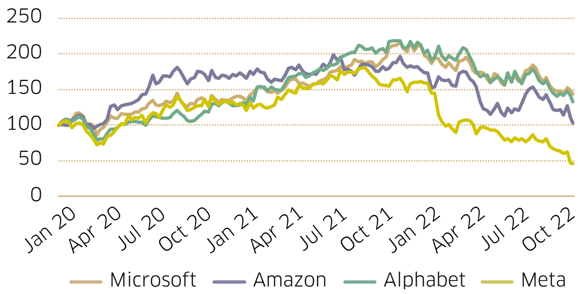
Source: Bloomberg, BAM

EQUITIES

Following the severe losses in September, equity markets bounced back impressively in October with market gains of 4.8% in the SPI, 9.4% in the Dax and 8% in the S&P 500. The reasons for this were the aforementioned easing up of long-term interest rates, the technical constellation of strong overselling and corporate results generally exceeding expectations. However, not all stocks were able to benefit from the favourable market sentiment. Among them, the former tech sector darlings Microsoft, Alphabet, Amazon and Meta, all of which disappointed with their quarterly results (see chart), proving that these companies are by no means immune to an economic downturn.

The question is now whether equity markets will be able keep up the positive momentum until the end of the year or perhaps beyond. This will depend essentially on the performance of expected corporate earnings and monetary policy moves. In current reporting, CEOs are being quite cautious about their outlooks. The challenges they face are: a weaker economy with dwindling consumer confidence, notably in Europe, increasing input costs (wages, energy, commodities) and – for US companies – the strong US dollar. We anticipate some margin pressure and we do not see much positive momentum emanating from corporate earnings. As for monetary policy, speculation on early easing has so far always reliably ended in disappointment. We would therefore not count on it now either and we see a volatile sideways development as the most likely scenario for equity markets for the coming weeks.

Tech stocks facing harsh reality (indexed at 01.01.2020 = 100)



Source: Bloomberg, BAM

INTEREST RATES

Long-term interest rates in Switzerland and the euro zone recently moved sideways on balance and in the UK the interest rate market calmed down after the resignation of Liz Truss. US interest rates rose to 4.25% in the course of the month and only began to ease again, since several Federal Reserve (Fed) members criticised the interest rate steps as being too aggressive. Such criticism is perfectly spot on, because higher interest rates affect the economy with a time lag. After the 75 basis point hike last Wednesday, two smaller steps may follow in December and February 2023, before the Fed then takes a break in the spring. Inflation could quite possibly ease by then. We see the 15% drop in used car prices as a first sign in this direction. The European Central Bank (ECB) also raised rates by 75 basis points to 1.5% (deposit rate). It is likely to continue raising rates, but less aggressively so than the Fed, given the looming risk of a recession. The worst should thus be over at the long end of the interest rate curve. This is especially true for the US, where real interest rates have reached an attractive level of around 1.5%.

Asset class	Appraisal	Commentary
Bonds Government bonds Corporate bonds		Central banks have not yet completed their interest rate cycles. At the long end, the worst is probably over for now.
Equities Switzerland Eurozone United Kingdom US Emerging markets		In October, equity markets bounced back as expected. However, cautious outlooks are dominating the reporting season, which signals some difficulties in the weeks ahead.
Real Estate Switzerland		Real estate investments have recently broken free from the lows. Hence, valuations have risen a bit, but are still comparatively favourable.
Commodities Oil Gold		Gold dropped further in October, but has bottomed out for the time being. The oil price should stay stable, as production cuts and the weaker economy balance each other out.

unattractive — attractive | Current asset class assessment

Imprint

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